May 7, 2010

The Honorable Chris Dodd
Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, DC 20510

Re: Addition Directing SEC/CFTC Report and Possible Action on Yesterday's "Unusual Market Activity"

Dear Chairman Dodd:

Yesterday was one of the wildest trading days ever on Wall Street, when stock prices plummeted precipitously in a manner of minutes and, just as quickly, recovered much of the lost ground. In the aftermath of these events, high-frequency and electronic trading algorithms have become the focus of intensified scrutiny.

Markets have always had "fat finger" errors and human-generated operational risks. However, it is becoming apparent that the proliferation of competing complex computer models has the potential to magnify and exacerbate these problems in a way that damages market integrity and confidence. We are concerned that as markets rely on and trust such a high percentage of the capital management of the market to black-box trading systems that systemic problems may be created. An estimated 70 percent of daily trading volumes are computer-driven trades taking place in microseconds, reducing the ability of humans to evaluate whether or not trades make sense in the context of their models or even if those models are working as intended.

Initial indications are that yesterday's events may be an example of computerized trading running amok. If this proves to be the case, perhaps there will be a certain reprogramming of systems to address this specific event. Nevertheless, not all scenarios can be anticipated or accounted for and as these programs are constantly changing there is a recurring risk of creating new programming errors. A temporary $1 trillion drop in market value is an unacceptable consequence of a software glitch.

The Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) released a statement yesterday that they are working together with the exchanges to undertake a review of yesterday's "unusual trading activity" and that they will make public the findings of their review along with recommendations for appropriate action.

We believe the Senate needs to underscore the importance of that review and provide input on some of the questions that the resulting potential recommendations should answer. The Senate has heard debate about algorithmic and high frequency trading and whether sufficient market safeguards are in place. Senator Jack Reed chaired a hearing on October 28, 2009, on some of the issues in the Subcommittee on Securities, Insurance and Investment.

High-speed, high-frequency algorithmic trading practices are relatively new and continue to evolve; their implications are not understood well enough. Recognizing this deficiency, the SEC issued a concept release on January 13th to study comprehensively a range of market structure issues, including a review of high frequency trading practices, any systemic risks those strategies may pose to the equities markets, and the possibility of manipulative strategies employed by high frequency trading algorithms that are or should be illegal. The comment period on the concept release recently ended on April 21st.

In conjunction with concerns about the systemic risks associated with certain high frequency trading practices, the SEC also issued a proposed rule on January 13th dealing with so-called "naked access," when high frequency traders place orders directly on a market center without being subject to pre-trade risk controls. Moreover, on April 14th, the SEC issued a proposed rule requiring the tagging of high frequency traders over a certain volume threshold, so that broker dealers for the first time will compile data on high frequency traders using unique identification numbers.

Accordingly, we have provided a recommended insert for the Manager's Amendment of the Wall Street Reform Act. It would simply direct the SEC and CFTC to report to the Congress within 60 days of the enactment of the Act on the following:

- The causes of yesterday's incident;

- How the SEC can evaluate whether the proprietary trading activities of major banks employ algorithmic trading practices that represent potential systemic risks to the markets;

- The potential need for industry-wide pre-trade operational risk controls that would minimize the incidence and magnitude of any trading errors; and

- How the agencies can gain analytical assistance from academics and private analytic firms under controlled conditions to conduct analyses on whether certain algorithmic trading strategies are harmful to the interests of long-term investors.

- How the agencies intend to "tag" high frequency traders over a certain volume threshold and use the data collected to gain a better baseline understanding about high frequency trading activities.

Furthermore, the amendment would direct the SEC and CFTC to report to Congress within 180 days on the following:

- Whether the agencies should insist on "shock absorber" or circuit breaker mechanisms to prevent computer-driven trading from running amok without the intervention of human judgment;

- How the agencies intend to "tag" high frequency traders and use data collected about high frequency trading activities, along with a consolidated audit trail, to detect any manipulative trading strategies; and

- Whether certain electronic liquidity providers which are currently unregulated but purport to be acting like market makers should be required to maintain "fair and orderly markets."

Thank you very much for your consideration of this request.

Sincerely,

Ted Kaufman

Edward E. Kaufman
United States Senator

Mark R Warner

Mark R. Warner
United States Senator

ATTACHMENT

cc: The Honorable Jack Reed

KAUFMAN-WARNER ADDITION:
SEC AND HIGH FREQUENCY TRADING

Given the potential algorithmic trading errors that may have caused a precipitous and dramatic decline in the U.S. equity markets on May 6, 2010 -- leading the Dow Jones Industrial Average to drop an estimated 481 points in six minutes and recover an estimated 502 points in the next ten minutes – Congress should require the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) to do the following: study and report on this incident, and report on the need for rules that would require – among other things – industry-wide implementation of pre-trade operational risk controls to minimize the incidence and magnitude of such trading errors.

High-speed, high-frequency algorithmic trading practices are relatively new and continue to evolve; their implications are not understood well enough. Recognizing this deficiency, the SEC issued a concept release on January 13th to study comprehensively a range of market structure issues. These include a review of high frequency trading practices, any systemic risks those strategies may pose to the equities markets, and the possibility of manipulative strategies employed by high frequency trading algorithms that are or should be illegal. The comment period on the concept release recently ended on April 21st.

In conjunction with concerns about the systemic risks associated with certain high frequency trading practices, the SEC also issued a proposed rule on January 13th dealing with so-called "naked access," when high frequency traders place orders directly on a market center without being subject to pre-trade risk controls.

Moreover, on April 14th, the SEC issued a proposed rule requiring the tagging of high frequency traders over a certain volume threshold, so that broker-dealers for the first time will compile data on high frequency traders using unique identification numbers.

The Kaufman-Warner addition would direct the SEC and CFTC to report to the Congress within 60 days of the enactment of the Act on the following:

- The causes of any trading errors on May 6, 2010 and whether any of those errors and the lack of pre-trade controls that permitted them to occur are indicative of continuing systemic risks to the markets that require further rule-making;

- How the agencies can evaluate whether the proprietary trading activities of major banks employ algorithmic trading practices that represent potential systemic risks to the markets;

- Regardless of the events of May 6, 2010, the potential need to ensure that broker-dealers and other high frequency trading platforms – on an industry-wide and market-wide basis -- implement appropriate pre-trade operational risk controls to minimize the incidence and magnitude of such trading errors;

- Whether the agencies have the internal capability to analyze high frequency trading data and detect manipulative trading strategies. If not, whether the agencies should mask the proprietary nature of such data and either (1) release it to the marketplace, or (2) release it under "hold confidential" agreements to academics and private analytic firms that can assist the agencies in conducting analyses about whether certain high frequency trading strategies are harmful to the interests of long-term investors; and

- How the agencies intend to "tag" high frequency traders over a certain volume threshold and use the data collected to gain a better baseline understanding about high frequency trading activities.

Furthermore, the addition would direct the SEC and CFTC to report to Congress within 180 days on the following:

- Whether the agencies should insist on "shock absorber" or circuit breaker mechanisms, potentially applied at the stock level, to prevent computer-driven trading from running amok without the intervention of human judgment;

- How the SEC intends to use the high frequency trading data collected under its proposed rule to "tag" high frequency traders, along with the development of a consolidated audit trail, to detect any manipulative trading strategies; and

- Whether certain electronic liquidity providers which are currently unregulated but purport to be acting like market makers should be required to maintain "fair and orderly markets."